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Stability and Growth Pact:
How Much Co-ordination in an Expanding Union?

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1. Introduction

The EU Stability and Growth Pact (SGP), at least in theory, sets out how budgetary discipline is to be enforced within Economic and Monetary Union (EMU). The adoption of the SGP was intended to strengthen the original fiscal provisions contained in the Maastricht Treaty. Indeed it is worth recalling that at the time of the SGP inception, doubts about whether EMU would take place at all were widespread; so the Pact and its rules were an important component in building expectations and confidence in the nascent currency at that time. The requirement that fiscal policy be put on a sound footing for membership of monetary union, when tied to the credible threat of exclusion for non-compliance, was successful in the 1990s. However, without the presence of credible penalties or sound intellectual reasons for compliance, the SGP in its current form is increasingly looking like a used ticket. Indeed, it has the hallmarks of making for a classic example of time inconsistent policy making given that that when it constraints became binding for a number of major EU economies, significant challenges to the credibility of the underlying rules emerged.

The aim of the fiscal framework within EMU is to combine flexibility with discipline, or economic growth with fiscal stability as the SGP title tries to, albeit inelegantly, capture. The desire for flexibility is to allow room for manoeuvre over the course of an economic cycle for fiscal policy to provide a stabilising role. The Pact has two dimensions it needs to address (i) the cyclical dimension and (ii) the transitional growth dimension. The former is topical with large EMU participants finding it more benign to set aside the SGP as they cope with a cyclical downturn while arguably the latter dimension is becoming more significant given the needs of the evolving union encompassing countries that cover a wide spectrum of stages of development.

While EMU was seen as having broadly favourable economic consequences by its founder members, the creation of the common currency changed the operating environment for all member economies by creating new channels through which the actions of individual members states could adversely affect the citizens of other members. It is this possibility of negative externalities for the union from fiscal policy in individual members (or a group of members) that required the addition of new rules for coordinating fiscal policy. Given that fiscal policies are pursued by national governments under the *Principle of Subsidiarity*, the SGP attempts to ensure fiscal discipline among participants in order to derive credibility to avoid placing undue pressures upon common monetary policy set by the European Central Bank (ECB) in its pursuit of price stability. Within EMU, it is the aggregate fiscal stance that is relevant for the policy mix at the euro-area level and it is to this fiscal position that the ECB's reaction function should be attuned to. The aggregation of nationally determined fiscal policies is unlikely to result in the optimal fiscal stance at the euro level and hence the desire for a fiscal co-ordination mechanism (Buti *et al*., 2003).

Co-ordination of fiscal policies is desirable in a monetary union and the case for co-ordination may be expected to strengthen as the common currency area membership expands. Our paper, however, argues that the case for co-ordination in dealing specifically with the potential spillover inflationary threat to all currency union members from inappropriate fiscal policies in one member state is less compelling than commonly supposed. In addition, we argue that the common rules in the "one size fits all" approach of the current formulation of the SGP may not be suitable in the expanding EU as countries arrive at differing stages of development, debt positions and demographic profiles.

The next section sets out the perceived needs for fiscal policy coordination under EMU. In Section 3 we use model simulations based on the NIESR NiGEM model to examine the beneficial impacts of policy co-ordination to deal with the spillovers from fiscal policy shocks. Section 4 looks at the implications of the EU expansion for fiscal policy frameworks, the limitation of the SGP and the required reforms. Section 5 concludes.

2. Need for Fiscal Co-ordination Within Monetary Union

There are generally three main channels stressed through which economic policy in member states can potentially cause collateral damage to other members of a monetary union. The first is that problems with the security of the banking system in one region could potentially affect all member states. The second is that potential debt default in one region could add to the risk premium payable by all other member governments, seriously raising the cost of capital even in spite of the “no bail-out” agreement. The third arises from inappropriate expansionary fiscal policy in a region of the EMU adding to inflationary pressures in the union which could cause the ECB to raise interest rates, penalising those economies that had pursued sensible policies.

The SGP does not address the first possibility of financial instability. Instead it targets the latter two channels through its commitment to budgetary balance over the cycle and a limit on annual fiscal deficits of 3% of GDP. However, two questions must be asked about the SGP in its present form: is it effective in tackling the increased dangers from unwise fiscal policy action that arise from the creation of the monetary union?; and does it respect the principle of subsidiarity in requiring no more co-ordination of fiscal policy than is necessary to tackle these dangers of debt default and spillover inflation?

Danger of Default

The current SGP involves rules covering both the debt-GDP ratio and borrowing as a percentage of GDP. However, if the only concern were the possibility of a government becoming insolvent, then the borrowing criterion is redundant. Pisani-Ferry (2002) argued that if solvency were the only concern, the rules of the SGP should be amended so that if a country's debt-GDP ratio were below a certain specified level (e.g. 60%), a country should not be required to maintain a balanced budget over the cycle. In addition, requirement to maintain stricter accounting standards to ensure transparency would be required. However, because it is written into the treaty, the 3% limit on borrowing would still apply for legal reasons, even if not for economic rrationale.

Such a rule would certainly protect members of the EMU from the danger of any individual country becoming insolvent. It would also meet the subsidiarity criterion by allowing individual countries that meet the debt criterion considerable scope to choose their own fiscal policy stance. However, it would not deal with the danger that an inflationary fiscal policy pursued by one or a number of members of the union would impact unfavourably on other member states pursuing a non-inflationary policy.

This proposal still leaves a problem in choosing the appropriate debt-GDP ratio below which countries would be free to choose. The appropriate debt-GDP ratio for individual countries is likely to show considerable variation and a "one size fits all policy", while having the attraction of being simple, is unlikely to be optimal from the point of view of maximising the utility of individual countries, or of the union as a whole. There is already considerable variation in the demographic profiles of the member states of the union, and the recent EU enlargement, with many additional countries eventually joining the EMU, makes the adoption of a single rule on the appropriate debt-GDP ratio sub-optimal. In particular, where countries have a major deficit in public infrastructure, or where the demographic profile is particularly favourable, it is possible that higher levels of debt may be optimal which we return to in Section 4.

In Germany, France, and Italy in the 1960s and the 1970s, the investment to GDP ratio was close to 25% whereas today it is around 20%. This is reflected in the fact that public investment in infrastructure was also significantly higher than today. If these countries had been constrained from borrowing to fund infrastructural investment in the 1960s and the 1970s it could well have adversely affected their long-term growth potential. In the case of the current cohesion countries in the EU, investment rates are running significantly higher than in the other EU members. This reflects the infrastructural deficits that exist in these countries. A severe constraint on public borrowing in these countries, and in the new accession countries, could also slow their rate of convergence in living standards. Wagner’s Law illustrates the tendency for a positive correlation to persist across time and across countries between the level of income per capita and the share of national income devoted to public expenditure (Lane, 2000).

The restriction on borrowing also has implications for intergenerational equity. It means that the current generation in the cohesion or accession countries must carry, through current taxation, all the cost of putting in place infrastructure that will benefit future generations. While this may be appropriate where the demographic profile is unfavourable, it will not always be true. In the past, in Europe, significant borrowing was undertaken to put in place the infrastructure in those countries that are currently the wealthiest.

This concern that necessary public sector investment in infrastructure should not be constrained by too tight a limit on borrowing underlies the UK government's "golden rule": borrowing should only be undertaken to fund capital investment. However, experience elsewhere (for instance Ireland in the 1970s and Japan in the 1990s) indicates that such a rule is open to abuse through inappropriate classification of public expenditure to get round the constraint on borrowing. It also takes no account of depreciation of the existing stock of public infrastructure.

Blanchard and Giavazzi (2002) propose that instead of a golden rule, countries should be allowed to borrow to fund net public investment (net of depreciation) and they propose institutional safeguards that might provide some protection against abuse. This variant of the "golden rule" is more logical from an economic point of view in that the cost of capital consumption (depreciation) is a charge on current taxation. However, like the "golden rule" it would not constrain countries from undertaking necessary and desirable infrastructural investment. If such a rule were followed, in the long run public sector debt would equal the stock of public infrastructure.

Any such rules would probably also have to include an upper bound on the debt-GDP ratio to ensure that the union is protected from the dangers of an individual country becoming insolvent. Such insolvency could occur if, for example, there was over-investment in unproductive infrastructure. It would also have to include the 3% deficit rule unless and until such a rule was removed through an amendment to the treaty establishing the EMU. The removal of the 3% limit, while desirable, might be difficult to achieve, possibly involving a further referendum in certain member states.

Danger of Inflation Spillover

In co-ordinating the overall stance of fiscal policy in national economies in a monetary union, it is not necessary, or appropriate, to specify the mix of taxation and expenditure to be pursued in individual countries. What is important is the overall fiscal stance – the change in the cyclically adjusted deficit or surplus.[1] It is this change in government saving that represents the ultimate impact on demand in the euro area. Even if individual countries are to be constrained to follow a particular path in terms of the change in their government savings (deficit), they still have autonomy in determining what mix of expenditure and taxation they will use.

If fiscal policy at the level of the euro area is appropriate (that is not putting pressure on interest rates through creating inflationary pressures), then independent action by an individual economy does not adversely affect other members. However, if a fiscal stimulus in one country contributes to an inappropriate fiscal stance at the level of the euro area, there is the possibility that it will require a tightening of monetary policy, with negative consequences for all other EMU members. This potential negative externality is the second important reason for co-ordination of fiscal policies (Butti and Martinot, 2000). Outside the euro area this need for co-ordination would not arise because changes in demand in a country outside EMU would not have any significant direct effect on interest rates in the euro area.[2]

The example of German unification highlights the possible gains to be obtained from effective fiscal policy co-ordination at the level of the euro area. In 1990 the huge infrastructural deficit that existed in the Eastern Länder of the newly unified Germany posed major problems for its government. However, a decision was made that taxes would not be raised to cover the full costs of unification, and government borrowing grew rapidly. This provided a very strong demand stimulus to the German economy. This stimulus was further accentuated by the decision to convert East German savings into deutschmarks at par. The consequence of the stimulatory fiscal policy pursued in Germany was that the Bundesbank had to tighten German monetary policy to offset the inflationary impact of the demand stimulus. However, the rise in interest rates in Germany was transmitted to all the other members of the Exchange Rate Mechanism (ERM) in force within the European Monetary System (EMS). Given the nature of the ERM this meant that there were serious negative externalities for the rest of the EU from pro-cyclical German fiscal policy.

If EMU had begun in 1990, with effective co-ordination of fiscal policy, it is likely that fiscal policy in Germany would have been much tighter than was actually the case. The result would have been that the EU could have escaped the major rise in interest rates that actually occurred. Gagnon, Masson and McKibbin (1996) and Barrell, Pain and Hurst (1996),

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[1] While a stimulus can also be given by a balanced increase in expenditure and revenue the impact of such a stimulus (the balanced budget multiplier) will be small relative to a change in expenditure funded by borrowing.

[2] Co-ordinated fiscal policy action does not entail a harmonisation of tax or welfare rates across regional economies. A harmonisation of prices (including taxes and welfare rates) would prevent the normal adjustment processes necessary to promote convergence. Such differences are essential to ensure optimal use of resources within the euro area. However, there may be cases where discriminatory fiscal action may adversely affect other EU members but this will not be confined just to members of the euro area. It is also not an issue for the short-term management of the euro area economy and, as a result, it is not an issue to be considered in the guidelines for fiscal policy.

estimate that the cost of inappropriate fiscal policy in Germany in the early 1990s was a loss in GDP of 2 to 3 percentage points in the UK, France and other EU members (other than Germany). While the increased demand from Germany resulted in increased exports from other EU members, this beneficial effect was more than offset by the negative effects of higher interest rates.

This is a very clear example where co-ordination of fiscal policy could have been beneficial to the members of the EMS as a whole (as well as probably saving the German economy from some of its current difficulties). If there had been a monetary union in 1990 Germany would have had to take into account the wider impact of its fiscal policy stance. In turn this would have required higher taxation or lower current expenditure in Germany to pay for unification, but the consequence would have been much lower interest rates and higher growth elsewhere in the monetary union.

For the future, disruptive fiscal policy action in large members of EMU, or disruptive action by a combination of smaller members of EMU, could potentially impose significant economic costs on all member states. Under these circumstances it remains desirable that the EU Commission has the power to co-ordinate fiscal policy within the euro area. However, it is an empirical question whether this potential danger of inflationary pressures arising from inappropriate fiscal policy action in any one member state (or a combination of member states) is likely to occur. Additionally the question remains on how this co-ordination should be best achieved.

A study by Gros and Hobza (2001) using the EU model QUEST and the UK National Institute model NiGEM suggests that the dangers of such inflationary shocks from inappropriate fiscal policy are much less likely under EMU than under the old EMS. This is because the effects from a fiscal stimulus in one country on the euro area inflation rate will be much smaller than on the inflation rate of the country undertaking the stimulus. Because the ECB targets the euro area inflation rate, and is not charged with responsibility for regional inflation rates, its response would be very limited.

3. Simulations Examining Potential Benefits of Fiscal Co-ordination

In considering the dangers from fiscal spillovers under EMU we use the NIESR NiGEM model to consider how a fiscal stimulus in one region of the EMU can impact on other members of the common currency area. In this example we look at the wider effects of a fiscal stimulus in Germany under different monetary regimes. We consider the case of the current EMU regime and also the case of the EMS regime of the 1990s, where interest rates in the other EMS countries tended to track German rates. We look at the effects of a sustained rise in current government consumption in Germany of around 2% of GDP in 2003. This rise in expenditure is assumed to have been financed by borrowing.

Under the old EMS regime the effect of this stimulus would have been to raise the German rate of inflation, resulting in the price level peaking at over 0.6% above its baseline level. Using a standard reaction function, the Bundesbank would have raised interest rates, peaking at 0.8 percentage points above the baseline (Figure 1). Under the EMS regime, the rise in interest rates in France would have been of a similar order of magnitude. In contrast, under EMU the effect of the stimulus would be to raise the euro area rate of inflation to a peak of 0.3% above the baseline. As the ECB targets the euro area rate of inflation, this would result in a rise in a rise in euro interest rates, peaking at 0.3% above base, well below what would have happened under the EMS regime (Figure 1).

Figure 1: Effect of German Stimulus on Interest Rates

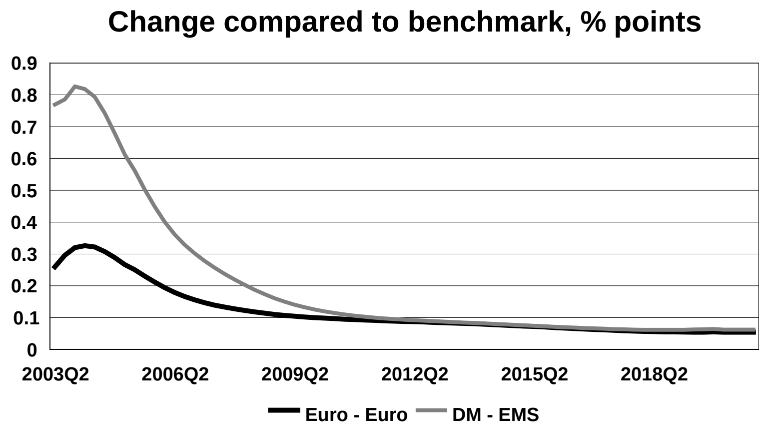


Figure 2: Effect of German Stimulus on German GDP

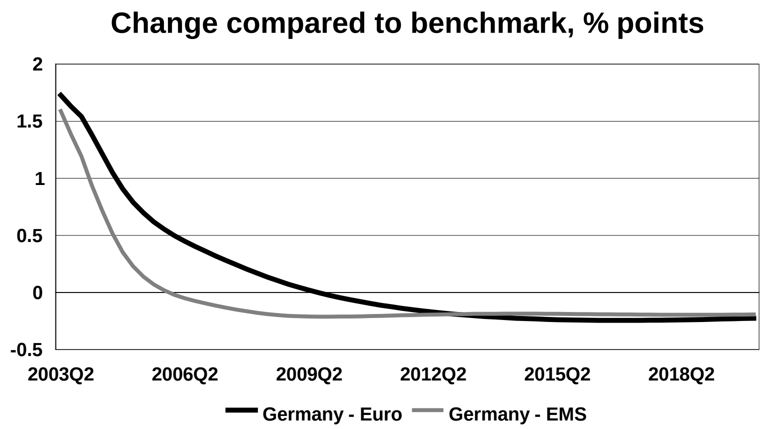
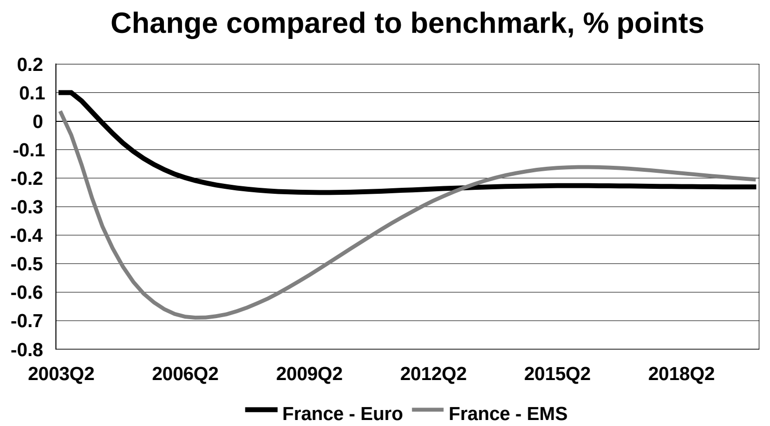


Figure 3: Effect of German Stimulus on French GDP



The result of this more “relaxed” monetary regime would be that the price level would peak in Germany at 1.2 percentage points above the baseline, significantly higher than would have been the case under the EMS.

The effects of the different regimes on GDP in Germany are shown in Figure 2. This shows a rather similar profile for the short-term impact on output. However, the EMU regime would see a somewhat slower fall-off in the positive impact on demand, reflecting the more “relaxed” monetary regime. The major difference between the two regimes would occur in the case of France and, by implication, the other members of EMU. Under the EMS, interest rates there would have risen by much more than would be the case under EMU. The result would have been that GDP would have fallen to a minimum of 0.7% below the baseline under the EMS. Instead under EMU, GDP would fall to a maximum of 0.25% below baseline.

What these simulations show is that the potential for unwise fiscal policy in Germany to damage the rest of the monetary union is much reduced under EMU compared to the EMS regime of the 1990s. In fact the damage done to neighbouring countries is likely to be quite small under EMU because the ECB targets the euro area inflation rate and because a fiscal stimulus in one economy, albeit a very large region such as Germany, cannot have a major impact on the euro area inflation rate. This suggests that the current concern with implementing co-ordination of fiscal policy, through the SGP, to protect the EMU from unwise action by any member economy is unnecessary.

In a separate set of simulations we considered the likely impact of a fiscal stimulus in Germany under an alternative regime where each member state pursued an independent monetary policy. The results of these simulations suggested that the negative impact on other EMU countries would not have been very different from what it would be under monetary union. In other words the potential for one member state to damage another through unwise fiscal policy is *de facto*, not greatly enhanced by the advent of EMU.

While in each case the impact of a fiscal stimulus in Germany has been considered on the French economy, the results for the other members of EMU would be broadly similar. It is also the case that the effect of a stimulus of a similar magnitude in any other country would have similar effects on the euro area economy. This suggests two conclusions:

1. Under EMU, unwise fiscal policy in one economy, including that of Germany, has very limited scope to damage the economy of the euro area as a whole.

2. This contrasts with the situation under the EMS where unwise fiscal policy in Germany could damage the economies of other EMS members.

Compared to a situation where each country acted independently, the advent of EMU has not greatly increased the exposure of members of EMU to unwise fiscal policy by any other member. An expanding monetary union reinforces this point.

These conclusions suggest that the SGP should be seen as the child of the EMS regime. Under that regime participants would have been significantly better off with a set of fiscal rules along the lines of the SGP. However, the potential benefits from enforcing the SGP under EMU are much smaller. The potential gains to be obtained from a rigid application of the SGP do not look to be worth the political capital that has been invested in trying to enforce them.

Obviously there may be exceptional cases where the adverse impact of unwise fiscal policy could be enhanced – where there are non-linearities not captured in the NiGEM model. However, these simulations suggest that over the next decade such events may be few and far between. If these results prove to be robust, they suggest that the concerns about an inappropriate inflationary fiscal policy in an individual euro area member (or even group of members) causing a substantial rise in interest rates are exaggerated. It would require a very big shock across more than one large member state before such a rise would be realised. The implication is that the SGP is probably too concerned with the issue of the short-term fiscal stance of member states of the EMU, potentially at the expense of longer-term growth prospects as we now turn to in Section 4.

4. Limitations of the SGP in an Expanding Union

The predominant analytical framework used to assess fiscal sustainability and the underpinning of the SGP numerical fiscal targets is based on inter-temporal budget dynamics. The level of debt sustainability is primarily determined by the growth potential of an economy and the initial existing debt level. Economies that borrow to finance public investment from a low debt position are being overly restricted by the SGP if their growth potentials are higher than the existing members of the euro area. This is the case for the new member countries of the EU that tend to have a substantially lower debt to GDP ratio than the previous incumbent members along with higher potential growth prospects. Given the importance of economic growth for public finance sustainability, there is a danger with the SGP that economies may be restricted or delayed in reaching their potential growth, which in turn could make attainment of their fiscal targets even more difficult.

New entrant countries can expect significantly higher growth rates in the medium to long term due to convergence forces. In fact, the 10 accession countries currently have a population of nearly 20% of the EU population but only have 5% of the EU total GDP. There is obviously quite a large scope for higher growth rates as these countries catch up to living standards in the wider EU. If an EU-15 nominal growth rate of 5% were to be assumed, as implicit in the SGP the debt sustainability and deficit conditions, together with a constant population share of the EU, then the acceding countries would require a nominal growth rate of over 14% per annum in order to converge in terms of GDP per head by 2020 (Cullen and McCoy, 2004). With this possible magnitude of growth rate the acceding countries on average could run consistent deficits in excess of 8% per annum and still maintain debt ratios of 60% of GDP.

The imposition of a uniform deficit limit may be open to criticism on two grounds, both with particular relevance to developing EU economies. First, from a pure fiscal sustainability perspective, uniform requirements of a 3 per cent deficit limit and budgetary positions close to balance or in surplus may make less sense when viewed from the varying stages of economic development across member states. The SGP 3 per cent deficit limit, for example, may be unnecessarily restrictive for ensuring fiscal sustainability in economies where nominal growth rates exceed 5 per cent. Achieving a budget balance that averages close to zero or in surplus over the economic cycle, as specified in the Pact, would be more restrictive again than what is required for a sustainable debt level. For fast-growing economies, therefore, the EU fiscal criteria may impose deficit requirements that go beyond what is required to achieve sustainable debt positions.

Secondly, the Pact rules may restrict government investment within EU member states. All other things being equal, increased government investment reduces the short-term budget balance and, consequently, increases the possibility of the member state concerned being found to be in violation of the Pact requirement of having a structural budget position close to balance or in surplus. If a member state is struggling to meet the close to balance requirement, either in the future or more immediately, reducing government investment before increasing taxes or reducing current expenditure may be a comparatively easy political option but would occur at a greater cost to the long-term development of the economy.

A reduction in government investment may be less critical in mature economies with an already well-developed infrastructure and where an improved primary balance may be of critical importance, either to reduce high debt ratios or to meet imminent increases in ageing-related expenditures. For other member states with comparatively low debt levels and favourable demographic prospects but with a poor and increasingly restrictive infrastructure, an improvement in the structural budget balance to the close to balance level may make little sense from either a fiscal sustainability or a long-term economic growth point of view. Fast-growing economies may even be in a position to run budget deficits in excess of the 3 per cent limit for investment purposes while still reducing their debt-to-GDP ratio. In this context, where some economies can achieve declining debt-to-GDP values with deficits in excess of 3 per cent and in need of a significant increase in government investment, there are some grounds for considering allowing the government deficit to exceed the 3 per cent limit for investment purposes.

The economic growth literature suggests that there may be some justification for an economy that has under-utilised resources, underdeveloped capital or deficient infrastructure running larger budget deficits for investment purposes than other countries (Cronin and McCoy, 2000). Fiscal rules designed to aid short-term macroeconomic management, however, may impede government investment programmes. With the existing EU member states having different medium-to-long term growth rate prospects and such differences across the EU likely to be accentuated if there are further accessions of new member states in the future, it is important that the implications of the fiscal rules for long-term economic growth are more closely examined.

Whether or not the SGP is to be reformed, it can be argued that by focusing undue attention on itself, it is distracting attention from consideration of the best economic approach to the difficulties of many euro area economies. An extensive economic literature has developed considering fiscal adjustments around the world over the last thirty years. Alesina and Perotti (1995) after reviewing the available literature, including the evidence from Ireland in the 1980s, drew conclusions as to the best approach to dealing with such problems. They concluded that when countries get into fiscal difficulties, urgent action, involving significant cuts in public expenditure, offers the best prospect of a return to growth. While tough action would undoubtedly deflate the relevant economy in the year it took place, the damage might be much less than would result from a fiscal war of attrition.

Eichengreen (1998) emphasises that the effects of a fiscal tightening will depend very much on the context in which the tightening takes place. In the current euro area context, fiscal attrition leaves consumers and investors uncertain about the future, resulting in depressed consumption and investment levels. While a short sharp shock will undoubtedly depress demand even more in the year it takes place, it holds out the prospect that from that point onwards things will continuously get better. Once consumers and investors respond, the public finances improve further and unemployment would begin to fall. Ireland experienced such a “virtuous circle” in the 1990s after a decade of wasted opportunities.

In the light of this literature, it might be in the best interests of some euro area governments if they took urgent action to reduce their fiscal imbalances through cutting expenditure. The desirability of this course has nothing to do with the SGP, but stems rather from the depressing effect on private sector expectations of the continuing focus on fiscal problems and the continuing ineffectiveness of governments in dealing with them.

With diverse domestic fiscal policy actions being required to reflect factors like age demographics and stages of development, achieving fiscal coordination through common sets of rules looks increasingly remote. Within the SGP, the target debt level has been effectively relegated with a focus firmly placed on the deficit ratio. The interactions between debt and deficits can become quite complex making it difficult to specify the joint rules implied under the SGP. The need for fiscal discipline and co-ordination within a monetary union, if agreed upon, can still be aided by the use of rules such as those contained with the SGP but this would encourage the search for a modification rather than an abandonment of the Pact.

Explicit acknowledgement of countries’ debt levels should play a pivotal role in any reform or modification of the SGP. This might involve creating a “Debt Sustainability Pact” alongside the SGP to provide member states with an “option” to exceed the deficit limits without incurring fines when the debt levels are sufficiently below agreed target debt levels (Pisani-Ferry, 2002). The Debt Sustainability Pact add-on could give countries the choice to opt –out of the Excessive Deficit Procedure. Instead, countries could agree to keep their debt to GDP ratios below some numerically agreed value.

In addition, to aid transparency and place the SGP firmly in a medium-term perspective, countries could be required to submit a debt programme specifying the benchmark for the anticipated debt progression over a 5-year period. This could shift the focus from monitoring deficits in a year-by-year basis to taking a medium term perspective on longer-term fiscal sustainability. Mathieu and Sterdyniak (2003) argue that national budgetary policies should be responsible for managing the trade-off between output and inflation using a medium term inflation target while monetary policy should target interest rates. The monitoring of the separate deficit or debt pacts would best be done in non-partisan way by the European Commission, though when it came to applying sanctions the Ecofin Council of Ministers would still need to be involved. Moreover, focus upon net public investment (Blanchard and Giavazzi, 2002) would be desirable as it would not constrain countries from undertaking necessary and desirable infrastructural investment while allowing economies make use of differential growth potentials in deciding upon the sustainable trajectory for their public finances. These “add ons” may also have the advantage of not opening a Pandora’s box by trying to reform the SGP just at the point where the union is rapidly expanding.

5. Conclusions

The SGP as it stands is not firmly grounded in economic logic, making it an ineffective instrument for achieving the necessary co-ordination of fiscal policy within the euro area. However, it is probably not the best time to change it radically, just when it is coming under political pressure due to unwise fiscal policies pursued in a number of member states. Change might be better undertaken once the current problems are resolved, ensuring that the credibility of having wiser rules in the future is not fatally damaged by a clear lack of political commitment. In the medium term it seems sensible to seek a reform of the SGP within the existing treaties, even if this means that some unsatisfactory provisions of the SGP are left in place.

As well as explicitly acknowledging a country’s debt level, the reforms should respect the principle of subsidiarity: the regulations should leave maximum powers to individual countries in the field of fiscal policy, subject to the need to ensure that unwise action by individual countries does not harm the interests of the EMU. As a measure of fiscal stance it seems preferable on economic grounds to use the cyclically adjusted deficit rather than the actual deficit. However, the difficulties in defining such a deficit may pose practical problems in implementation.

Co-ordination of fiscal policies to avoid inflationary pressure arising from a fiscal stimulus is probably less important than is commonly supposed. The occasions when action will be necessary to achieve such co-ordination will probably arise infrequently in the future. At no time since EMU began has this been a problem. While the fiscal policies of a number of member states are likely to breach the requirements of the SGP, there is no suggestion that these policies are currently causing inflationary pressures within the EMU. For the future, where inflationary pressures are present due to the combined fiscal stance of the EMU, it is might still be desirable to reserve the power to the European Commission to require the member states pursuing the most stimulatory fiscal policy to mend their ways.

The expansion of the EU and the consequential increase in the number of member countries will make effective co-ordination more difficult. Experience with the SGP since the start of EMU has shown that the rules as they now exist are non-credible and hence non-enforceable. Designing rules to achieve co-ordination within EMU will continue to fail unless the mechanisms are self-enforcing. This means that fiscal rules must be desirable for each country’s own economic circumstance. Given the heterogeneity that EU expansion has brought about among member economies, the SGP rules would need to cover a wider set of contingencies. While the European Commission (2002) proposals are moving the reform of the SGP on the right track, there continues to be strong resistance to change and a preference towards a benign neglect to what is now near universally accepted as inadequate fiscal rules for an economic downturn.

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